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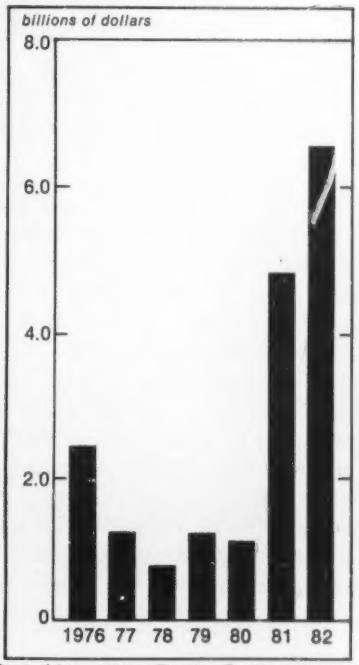
Is U.S. Money Growth A Foreign Affair?

The instability of U.S. money growth has been highly disturbing to economists and other analysts who favor close control of the domestic monetary aggregates. But their fears may stem more from the narrowness of their own assumptions than from any faulty execution of monetary policy. In its strictest form, this approach assumes that the target aggregates—M1 and M2, for example—reflect only the money holdings of U.S. residents. Furthermore, all of the money balances held by these residents are included in the domestic aggregates. No allowances are made for the effects of either currency substitution or "haven-currency" demand for dollar-denominated assets. Strict aggregates targeting thus fails to consider that residents may not always want to hold their assets in dollars and that non-resident holdings of dollar assets may constitute a significant portion of the domestic money stock. These assumptions need reconsideration. The shifts in asset preferences that have produced the wide swings in the foreign-exchange value of the dollar in recent years may well have been a major force behind the puzzling variability of U.S. money growth. (See page 7.)

Changes in private, non-bank foreign deposits in U.S. banks*



*net of International Banking Facility liabilities

For example, the increased "dollarization" of many developing economies—particularly Latin America—has certainly contributed to the rapid increase of U.S. monetary aggregates over the past year or so. The question is whether the effects of such shifts have been important. Unfortunately, this is not easy to determine from the information at hand. Data on foreign ownership of U.S. bank liabilities appear to be highly incomplete. And figures on resident holdings of monetary assets denominated in other currencies—and on the volume of U.S. currency in circulation abroad—are simply not available. The best that can be said is that the existing data are not inconsistent with the hypothesis that the currency preferences of both residents and non-residents are subject to significant swings that are related to the expected foreign-exchange value of the dollar.

These effects may also be important in explaining the behavior of U.S. money growth. The best evidence of this is that changes in U.S. domestic monetary aggregates provide a less complete explanation of changes in U.S. inflation than do changes in a more-comprehensive monetary measure —one including information on changes in domestic money stocks in other major-currency countries. This result also holds for the other major industrialized countries. Money clearly matters. It matters a lot. But the measure of money that matters the most in an era of highly interconnected capital markets is a wider concept than that captured in conventional domestic monetary statistics.

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British pound recovers but remains on shaky ground.

After some days trading close to a record low of $1.45, British sterling has risen steadily since the Easter weekend and, according to some pundits, is set to climb still further in the near term. To some extent, this rebound reflects sterling's status as a petrocurrency. There are a few signs that the downward pressure on oil prices has eased for the time being, reducing the chances of the uncontrolled fall in prices some observers had been predicting. However, there have been other forces behind sterling's resurrection: The domestic economy is now rebounding quite smartly—industrial production in March was up 2.9% from a year ago—and the business community has become markedly more optimistic. The current account is back in surplus after January's unexpected deficit. Moreover, the inflation rate is already down to a year-on-year rate of 5% and is set to fall still further soon. Furthermore, opinion polls continue to suggest that Mrs. Thatcher's government will be returned in the next election. Nonetheless, sterling remains somewhat risky. Oil prices are still far from stable. And on the domestic front, industrial unrest seems to be on the rise again after two relatively quiet years; this could shift opinion against the government. Finally, there is still no definite word on the election date. And uncertainties over the timing and the outcome of that event could yield substantial swings in the exchange rate over the next few months.

Economic recovery still fragile in Germany.

Recent economic statistics show that Germany's recession has bottomed out and that output is on the rise. Closer inspection of the data, however, suggests that, while the economy has indeed passed the trough, the extent of an upturn is still uncertain. Industrial production during the first two months of 1983 averaged only about 1.5% above the low level of the final two months of last year. Total industrial order volume was also up 1.5%, with a 0.5% rise in domestic orders and a 4.2% upturn in foreign orders. Both these components, however, appear to have been overstated—the domestic order picture by several large scale orders as well as the expiration of an investment incentive scheme at year-end 1982, and foreign orders by expectations of a mark revaluation in the European Monetary System. The boost lower interest rates are now giving construction activity and recent improvements in business and consumer confidence offer some encouragement for the outlook. However, consumers' real incomes are expected to decline again this year, and prospects in several of Germany's big export markets look distinctly poor. Thus, exaggerated optimism at this stage in the cycle only risks another consumer and investor retrenchment further down the line.

No major economic policy shift expected from Finland's new government.

Finland's March election produced some surprises. It had been clear in advance that support for the Euro-Communist party was declining. But instead of the expected swing toward the Conservative party, most of the gains were enjoyed by the small, farming-based Rural party, and by the "Green" environmental party, which entered parliament for the first time with two seats. The elections produced one of the biggest changes in Finnish history with one-third of the members of the previous parliament eliminated. Prime Minister Sorsa has now resigned, paving the way for President Koivisto to appoint a new government. It is clear that, despite these changes, the new government will continue to be based on a center-left coalition and that there will be no great shift in economic policy. The economy is, in fact, reasonably healthy despite a slowdown in trade with the Soviet Union. Inflation is expected to slow to around 8% in 1983 after last year's 9.3%. And economic growth should pick up toward 2% from 1% in 1982. Furthermore, the current account is expected to record a small surplus this year—the first surplus since 1978. Thus, an unchanged policy stance would seem appropriate.

Mexico continues to put its economic house back in order.

The Mexican government is persisting in its difficult economic adjustment program, despite a less-than-favorable external environment. Restrictive fiscal-policy measures in the form of higher taxes, lower subsidies, and reduced expenditures have been introduced relatively smoothly. In the meantime, the labor

sector has been unusually cooperative, accepting wage increases that fall well short of the 100%-inflation rate expected for 1983. External conditions may, nevertheless, ruffle the program. First-quarter disarray in the world oil markets seems to have affected Mexican petroleum exports. Preliminary estimates are that oil exports fell to 1.2 million barrels per day (b/d) in February and March—significantly lower than the 1983 official target of 1.5 million b/d. Moreover, although short-term international interest rates are currently below those used in the government's 1983 budget, these rates are holding firm. The general consensus is that they will fall no more than 100 basis points in the next quarter providing little additional relief this year to Mexico's large debt-service burden. Still, if the international oil markets hold firm for the balance of the year, Mexico could go through 1983 with little additional foreign borrowing.

Uruguay embarking on stabilization program to boost economic and financial prospects.

Extremely high real interest rates, reflecting a sharp reduction in foreign capital flows and fears of devaluation, led to an 8.5% drop in real GDP for Uruguay last year. At the same time, the fiscal deficit soared to the equivalent of 12.3% of GDP. In the external area, the current-account deficit rose to $514 million, chiefly because of higher interest payments on the external debt. The trade deficit actually improved substantially as imports plunged 40% owing to the drop in aggregate demand. To turn the economy's poor performance around, Uruguayan authorities have embarked on an stabilization program for which they are seeking the financial backing of the IMF. The program includes maintenance of a floating exchange rate, a refinancing of the country's short-term external debt, obtaining new money from foreign commercial banks, and most important, an extremely restrictive fiscal policy—the budgetary gap is to be lowered to 3% of GDP in one year.

Sri Lanka's 1983 budget authorizes tax hikes to offset higher spending.

The government of Sri Lanka announced in early March its long-delayed 1983 budget along with estimates of actual expenditures and receipts under the 1982 budget. Estimates put the 1982 deficit at 20.6 billion rupees, or an incredible 20% of GDP, although the shortfall was some 560 million rupees *less* than had been expected. To finance the gap, the government borrowed some 4 billion rupees from the domestic banking system, just over 1 billion rupees higher than had been originally planned. The 1983 budget provides for a further sizable increase in real spending, particularly in capital expenditures as work under the Mahaweli-Ganga Development Program peaks. To keep the budget deficit manageable, the government plans to raise additional taxes through a hike in the Business Turnover Tax, a sharp increase in import duties, and the elimination of some tax holidays. The net result is expected to be a deficit of 23.4 billion rupees —still extraordinarily large compared with current GDP forecasts. The government hopes to hold bank borrowing for deficit financing to a low 1.36 billion rupees—only 1% of projected total output. Nevertheless, the total public-sector claim on resources will continue to grow.

Soft oil market spells further narrowing of Kuwait's current-account surplus.

Kuwait registered a current-account surplus of an estimated $7.5 billion last year, down noticeably from 1981's $13.8 billion. The lower surplus reflected, in part, 9% growth in imports of goods and services as well as transfer payments. But the drop was mainly attributable to a 33% decline in merchandise export revenues to an estimated $10.5 billion in 1982 because of much lower gross oil exports. Not only did oil output shrink by 26% to a daily average of 828,000 b/d, but also the average official oil price fell by nearly $3.00 to $32.30 per barrel. Receipts from service exports—consisting mainly of investment income—came to an estimated $10.5 billion. Import growth is expected to moderate this year. Nevertheless, although investment income will remain sizable, the current-account surplus will shrink even further in 1983 because of lower oil income. The official oil price has already been cut to $27.30 per barrel as of March 1, and continued soft demand for oil will probably keep the country's output well below its OPEC-assigned quota of 1.05 million b/d. Accordingly, it is unlikely that Kuwait's surplus will exceed $5.0-5.5 billion in 1983.

Signs of an Unbalanced Recovery

The U.S. economy expanded at a 3.1% annual rate in the first quarter, according to preliminary data released by the Commerce Department last Wednesday. This quarterly performance was the strongest in two years, raising hopes that the sluggishness that has plagued the economy since 1979 may be coming to an end. But as pleasant the prospects of sustained growth might be, these latest data contain some disquieting hints that the U.S. economy is not all well yet.

First, the good news: The housing recovery has really taken hold. Residential construction rose at an annual rate of 83% in the first quarter, after a solid 40% gain in the fourth quarter of 1982. The most recent outsized increase contributed about two-and-a-half percentage points toward the overall rise in output.

Consumers also chipped-in to the output gain: Real personal-consumption expenditures rose 2.3% at an annual rate, despite a slowdown in the growth of personal income. A sharp deceleration of consumer prices, along with a slight decline in personal savings, made this advance possible.

Business investment also modestly added to the overall increase. After declining 8% during 1982, real nonresidential fixed investment rose at a 2.7% annual rate. However, large gains in just two sectors—transportation equipment and non-office commercial construction—were partially offset by declines in most other sectors.

Finally, the pace of inventory liquidation slowed considerably. This boosted GNP growth, but also slowed the adjustment of inventories to their desired levels.

On the negative side, the trade balance continued to be a drag on the economy. Export volume continued to decline, although at a much slower rate, while import volume jumped sharply. And government nondefense spending posted a large decline.

Adding up all the sectors, the pluses clearly outweigh the minuses, but the recovery is imbalanced. Even with further declines in interest rates, housing is extremely unlikely to repeat such large gains in the months ahead. Indeed, housing starts slipped back a bit in March from their extraordinarily high levels in January and February. Business investment may fall back somewhat, and the foreign-trade sector is likely to remain weak as recovery in the overseas economies lags behind that of the United States. And with inventories closer to their desired level, restocking is not likely to provide as much of a boost unless sales pick up sharply.

As is almost always the case, then, a sustained recovery rests on the ability and willingness of consumers to spend. Recent data on improving consumer confidence and income are encouraging, but the economy is still far too fragile for concerns to be completely laid to rest.

Douglas L. Bendt

New Phone Subsidy Puts Efficiency on Hold

Deregulation of an industry never runs smoothly. The program recently devised by a panel of the Federal Communications Commission (FCC) to ensure continued telephone service in all local areas after the 1984 divestiture of the American Telephone and Telegraph Company (AT&T) may solve one problem in the short run. But it is likely to impede progress toward a more efficient telecommunications system.

The AT&T system originally serviced only densely populated areas while other companies provided service in many of the more-rural areas. Later, AT&T was awarded a virtual monopoly in the provision of long-distance telephone service. In return, the company agreed to provide service to some of the higher-cost rural areas at the same rates as other local areas—their average cost—on the condition that it would be allowed to subsidize its unprofitable local markets with profits from its long-distance operation.

As AT&T grew, federal regulators began to question whether technological innovation in telecommunications might be better promoted through the introduction of more competition. Spurred by this shift in regulatory attitudes, new lower-cost technology, and the high profits of the long-distance segment of the industry, a trend toward increased competition emerged in the 1970s. This led to the 1982 consent decree in which AT&T agreed to divest itself of its local operating companies. Competitors are now able to tap the enormous profits of the long-distance market without the obligation of providing local service.

The FCC realized, however, that because of the AT&T divestiture, high-cost local exchange services would lose their subsidies, which could lead them to discontinue service in some areas. To ensure that universal telephone service would continue, the FCC panel has proposed that funds for a new subsidy be collected from the profits of all companies competing in the long-distance market. These companies also are to continue to pay access charges for the use of the local telephone networks required to connect individual callers.

The problems with this proposal are many. The current infrastructure of the local telephone networks—with its obsolete system of poles and wires—is expensive and far behind the state of the art in telecommunications technology. Continued subsidies will only reduce the incentives for development of more-efficient, lower-cost systems. Furthermore, as new firms enter the now-competitive long-distance market, its huge profits—and thus the funds for the subsidy—will be eroded.

Decreased revenue from this subsidy will force the local companies to charge higher access fees, encouraging long-distance companies and other corporations to devise new technologies that will bypass the local networks altogether. The costs of using antiquated technology will inevitably be borne by consumers who ultimately must either pay up or hang up.

Robert S. Smith
Terry S. Wiginton

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GDP IN 1982		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars April 20, 1983	change from year earlier	current monetary conditions	
Argentina	Rising grain exports and import-substitution industries spurring economic recovery.	Dec.	−18%	130.0	4,594	Dec.	2,506	− 23%	6.2	895	Private debt being rescheduled.	Feb.	+245%	Nov.	+242%	.000029	−65%	Central-bank credit restricted by IMF agreement.	Argentina
Brazil	Reported unemployment in key cities rises to 7.5% as industrial production and construction slow.	Dec.	−18%	293.0	2,382	Sept.	4,185	− 23%	2.4	544	Trade surplus improved in March.	Jan.	+105%	Nov.	+ 70%	.0022	−68%	Credit ceilings unchanged since early 1983.	Brazil
Chile	Measures introduced to provide relief on local and foreign debt.	Feb.	+ 1%	23.7	2,060	Feb.	1,544	− 48%	5.8	458	Reserves fell an additional $144 million in first half of March.	March	+ 25%	Dec.	− 8%	.0131	−51%	Liquidity continues to contract.	Chile
Colombia	Government gives financial aid and rescheduling help to ailing textile and steel industries.	Oct.	+ 9%	39.0	1,423	Feb.	3,528	− 23%	7.6	0	Exchange rate under pressure from neighboring-country devaluations.	March	+ 22%	Nov.	+ 20%	.0150	−29%	Bank reserve requirements cut to help liquidity.	Colombia
Costa Rica	All imports subjected to 40% duty in effort to boost government revenues.	Dec.	−15%	2.8	1,164	Feb.	291	+105%	3.9	109	Beef exports expected to be some 20% below last year's level.	Dec.	+ 82%	Nov.	+ 65%	.0250	−10%	Liquidity is tight.	Costa Rica
Ecuador	Exchange rate devalued and public spending cut to help balance of payments.	Nov.	−20%	14.0	1,573	Feb.	262	− 58%	1.6	0	Private-debt refinancing planned.	Dec.	+ 23%	Sept.	+ 25%	.0140	−42%	Credit restricted by central bank.	Ecuador
Guatemala	Government announces 10% budget cut in anticipation of IMF loan.	Dec.	+17%	8.4	1,090	Feb.	68	− 18%	0.6	104	Storm damages cause loss of about $60 million in banana export earnings.	Dec.	− 2%	Nov.	+ 5%	Par	—	Monetary stance is restrictive.	Guatemala
Guyana	Negotiations being resumed with IMF after previous program lapses.	Dec.	−24%	0.4	490	Feb.	6	+140%	0.3	84	Loan payments in arrears.	Sept.	+ 19%	Jan.	+ 28%	.3921	+18%	Domestic credit is scarce.	Guyana
Honduras	Major Honduran conglomerate, Grupo Continental, expected to increase investment.	Oct.	−22%	2.8	718	Feb.	129	+ 26%	2.4	103	World Bank to increase funding to $100 mn. from $30 mn. in 1982.	Oct.	+ 11%	Oct.	− 13%	.5000	0	Limit of $60 mn. set on banks' foreign-currency deposits.	Honduras
Jamaica	Expected loss of about $200 million in bauxite earnings exerts pressures for tighter fiscal policy	Dec.	−27%	3.1	1,378	Jan.	90	− 26%	0.7	612	Agreement reached to sell 1 million tons of bauxite annually to USSR.	Dec.	+ 7%	Dec.	+ 46%	.5600	− 2%	Credit policy remains tight.	Jamaica
Mexico	Government to provide subsidized dollars for repayment of private-sector foreign debt.	Dec.	+ 8%	207.0	2,248	July	1,629	− 44%	1.3	328	First-quarter oil export earnings expected to be lower than official projections.	Dec.	+ 99%	Sept.	+ 58%	.0065	−70%	Credit growth being restricted.	Mexico
Nicaragua	Over $200 million in new loans obtained from official lending institutions.	Dec. '81	+11%	2.7	930	June	110*	+ 13%	1.5	19	Venezuelan oil-import aid suspended.	Dec.	+ 30%	June	+ 32%	.0993	0	Net foreign assets at low level.	Nicaragua
Panama	Government austerity being implemented in effort to reduce foreign borrowing requirements.	Dec.	+64%	4.0	2,020	Dec.	101	− 16%	0.8	82	Rise in Canal income helps balance of payments.	Jan.	+ 3%	Dec.	+ 5%	Par	—	Domestic credit rises in real terms.	Panama
Paraguay	Currency devaluations and economic problems in Brazil and Argentina adversely affect business.	Nov.	+ 7%	5.7	1,691	Feb.	657	− 14%	12.1	0	Reserves drop as capital inflows decline.	Dec.	+ 4%	Aug.	− 4%	.00794	0	Credit is very restrictive.	Paraguay
Peru	Fiscal policy turns more restrictive; inflation at 85% annual rate.	Dec.	+ 1%	19.8	1,053	Jan.	1,156	0	4.1	628	Oil income will be down sharply owing to production problems, lower prices.	Feb.	+ 85%	Dec.	+ 35%	.00094	−44%	Credit policy is tight.	Peru
Puerto Rico	Economy beginning to recover from deep recession, paced by electronics, pharmaceuticals industries.	Dec.	+ 6%	12.6	3,875	Jan.	11,800**	− 1%	19.7	0	Foreign trade in surplus.	Jan.	+ 1%	Jan.	+ 1%	Par	—	Bank deposits increase.	Puerto Rico
Uruguay	Wide-ranging tariff-reduction program implemented to help offset burden caused by sharp devaluation.	Nov.	−12%	9.4	3,240	Dec.	116	− 73%	1.5	82	Principal payments on short-term debt suspended for 90 days.	March	+ 43%	Aug.	− 12%	.0295	−67%	Credit growth being constrained.	Uruguay
Venezuela	Government spending reduced by 7.5% as part of stabilization program.	Nov.	− 8%	73.0	4,966	Feb.	5,355	− 27%	5.2	0	Private debt receives preferential exchange rate.	Dec.	+ 8%	Nov.	+ 19%	.1081	−54%	Credit program is restrictive.	Venezuela

*Foreign assets **Commercial bank deposits

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World Interest Rates

market rates as of April 20, 1983; bond yields as of April 15, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.49	10.063 intervention rate	10.00	9.50	4.00	17.00 penalty rate 20.00	3.50	4.00	5.50
Day-to-Day Money	8.625 April 21	10.00	10.125	9.50	12.75	4.85	18.00	6.00	3.50 1-month Euro-Swiss fr. rate	6.188
Treasury Bills 91-day, Middle Rates	8.07	9.20	9.844	10.75	n. a.	n. a.	16.003 71 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.875 finance paper discount basis	9.30 finance paper 15% tax w/h	10.062	9.90 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	9.25 15% tax w/h	9.844	9.90 Certified	not traded	5.00	19.30	no market	4.188	no market
Government Bonds Long-term, new and old issues, average yield	10.51	11.27	10.19	10.52	13.77	7.55	18.14	8.04	4.44	7.131
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	11.91	12.02	14.74	14.90	7.60	17.76	8.29	5.71	6.47
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.50	14.55	8.00	19.50 ⅛ qtrly fee on outstdng.	6.00	7.50	6.00
Bank Time Deposits 3-month	8.45 Cert. of Dep.	9.25	10.25	10.50	12.375	4.90	11.50	5.625 large deposits	3.25 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.375	9.625	10.313	nr market	14.625	5.063	no market	5.50	4.375	6.313
Exchange Rates—in U.S.$ rates floating against the $	—	.8085	1.563	.0204	.1356	.4068	.00068	.3617	.4840	.0042
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.198 *D*	1.024 *D*	1.430 *D*	4.425 *D*	4.326 *P*	7.018 *D*	3.871 *P*	5.124 *P*	2.947 *P*

Eurodollar Deposits
(London, interbank, bid)
April 21

7-day	8.938
1-month	9.00
3-month	9.125
6-month	9.25

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.615
U.S.-Canada Treasury Bills	−0.602
U.S.-Canada Finance Co. Paper	−0.100
Eurodollars-U.K. Local Auth. Deposits	+0.274

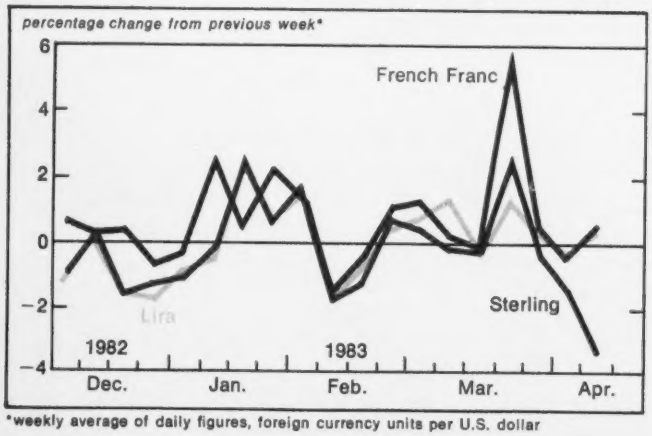
Eurobonds
(average yield on recent straight debt issues)

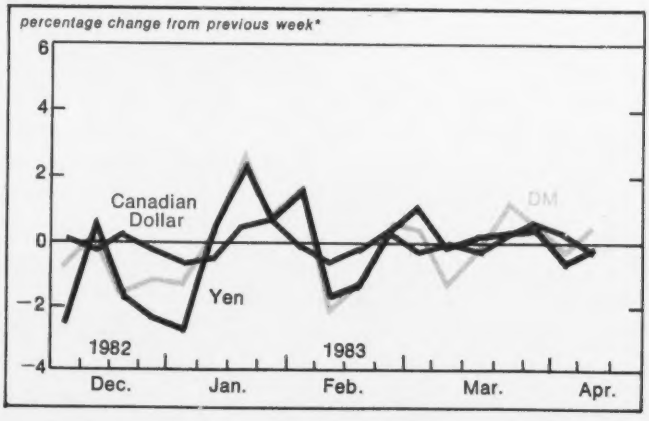
U.S. Dollar Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.75
DM Bonds	
7 yrs. and under	7.25
Over 7 yrs.	7.50

Gold Price
London afternoon fixing
433.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of the dollar against major currencies





*weekly average of daily figures, foreign currency units per U.S. dollar

Monetary Policy: The Bulge That Binds

The persistent rapid money growth of the last six months is threatening to unravel the Federal Reserve's inflation-fighting credibility earned during the 1979-82 era of strict aggregates targeting. Repeated disclaimers by Fed officials—assertions that the money bulge is merely the result of technical distortions caused by the introduction of new bank accounts—appear to be wearing thin. And the recent backup in interest rates is, in part, indicative of growing market fears that monetary policymakers may be reverting back to the expansionary tactics of the 1970s. Unless the monetary buildup is soon reversed or unless a more plausible explanation can be found, market skepticism could force the Fed to tighten actively as a demonstration of its resolve not to pursue inflationary policies. This would temporarily drive up short-term rates and possibly choke off the still-fragile economic recovery.

The unfortunate aspect of the whole matter is that market concern may be misplaced. It is highly probable Fed officials are actually telling the truth when they insist they are not pursuing an inflationary monetary policy. Much of the acceleration in money growth may be the result of demand forces that the Fed is simply accommodating. There are a number of reasons businesses and individuals may just want to hold higher levels of money balances—without immediately spending them. If this is true, then the stepped-up monetary expansion carries no serious inflationary implications and there is, in fact, no need for the Fed to tighten.

A number of reasons have been put forth as to why the public's preference for cash balances may have risen:

- The creation of interest-bearing checking accounts, such as the "Super-NOW accounts—the Fed's own rationale for the money bulge—has reduced the cost of holding transaction balances, encouraging businesses and consumers to keep larger amounts of readily available funds on hand.
- Greater uncertainty over interest rates, price movements, employment, and the overall health of the economy has increased the desire to maintain greater precautionary money balances.
- As a result of increased efforts to hide transactions and wealth from the government, the so-called "underground economy" has mushroomed, stepping up the demand for currency, and possibly expanding demand deposits as well.
- The tax cut and other new incentives for savings implemented by the Reagan administration have enhanced the relative attractiveness of financial assets compared with real assets or consumption—including those relatively liquid financial assets measured as part of M1 and M2.

In addition to these principally domestic influences, however, there are international sources of change—largely overlooked—that may offer clues as to whether the surge in U.S. money growth is actually the result of a benign upward shift in money demand. These stem from the sizable inflow of foreign capital into the United States during the past year.

Altered preferences

Because of more-pronounced uncertainties abroad and the renewed and sustained strength of the dollar in the foreign-exchange markets, foreigners have apparently developed a greater preference for dollar assets. For 1982 as a whole, foreign assets in the United States rose by some $87.3 billion, an increase 41% greater than the 1981 inflow. Conceivably, a good portion of the rise in the U.S. money supply could have come from this change in currency preference.

Although the reported growth of foreign deposits in the United States was substantial—$33.5 billion in 1982 and $13.9 billion in 1981, according to the international-capital data of the U.S. Treasury—only a small portion was captured in the U.S. monetary aggregates. The deposits of foreign governments and banks, as well as International Banking Facility deposits, are excluded from U.S. money-supply figures. And no more than $2-3 billion of the $42-billion increase in M2 in the fourth quarter of last year can be traced directly to the growth of deposits by foreigners. The overall impact, however, was undoubtedly much greater. Once indirect and unreported flow effects are taken into account, the impact of the change in preference for dollar assets on the U.S. monetary aggregates appears to have been quite substantial.

The reported data captured only a fraction of the actual increase in foreign financial assets coming into the United States. Closer examination of the data shows that a large percentage of the foreign capital inflows came from Latin American countries. Because of existing political and economic tensions, many Latin American residents may have had strong incentives to disguise ownership of their financial assets from the U.S. government. Given the proximity of these countries to the United States and the close personal ties many Latin American residents have with U.S. residents, substantial funds easily could have entered the country unreported and could have been maintained in accounts not identified as foreign. In many cases, these funds would be counted in Federal Reserve money-supply figures but would not show up as foreign assets in the Treasury reports.

The so-called "statistical-discrepancy" line of the U.S. balance-of-payments statistics—which captures what is unreported as well as errors—supports the

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conjecture that the second half of last year saw a marked shift into dollar assets. Third-quarter 1982 figures (the latest period for which data are available) show a $12.4-billion unexplained flow of funds into the United States from Latin America. This is a striking difference from the $2.4 billion outflow and $1.4 billion inflow of the first and second quarters, respectively.

There are other indirect ways a shift in currency preferences may have affected the growth of the U.S. monetary aggregates. For example, net foreign purchases of U.S. securities rose some $24.2 billion in 1982. If a foreigner bought dollar securities from a U.S. resident, foreign deposits would be transferred to the checking account of the domestic seller, increasing the level of demand deposits in the United States and thus, the money supply—at least temporarily. A similar effect would result if foreign companies—because of such influences as relatively high U.S. interest rates or adverse exchange-rate movements—decided to reduce the level of outstanding credit extended to them by U.S. exporters. The most recent U.S. statistics show that net non-bank claims on foreigners fell some $5.2 billion in the first nine months of 1982.

One of the most important generators of currency-substitution effects on the U.S. money supply might have been the portfolio-management activities of U.S. multinational corporations. These firms, whose financial assets are located in many countries and denominated in a variety of currencies, may also have found dollar balances to be preferable to balances in other currencies. If so, they may have run down their balances abroad in making payments while building up balances at home. Such moves would have contributed to an increase in money demand in the United States that would not be easily identified from the collected statistics of the monetary authorities.

Policy dilemma

Many of these potential sources of a shift in currency preference in favor of the dollar are difficult or even impossible to verify. Nevertheless, like the domestic influences mentioned earlier, they do raise serious questions about possible shifts in the demand for money in the United States. It seems quite probable that there has been a significant increase in U.S. money demand. This would go a long way toward explaining why the United States has continued to experience the odd combination of sluggish growth, still-declining inflation, and a strong dollar, despite persistently robust growth in the supply of money.

The verification of a change in money demand has important policy implications. In 1937, the Federal Reserve—seeing the banking system with a high level of excess reserves and fearing the inflationary potential of such a situation—raised reserve requirements. In doing so, it helped to abort the recovery from the Great Depression. Fed officials at the time failed to take account of the fact that the banks had built up reserves not out of a desire to lend, but as a precaution against further runs on the banks. That is, the monetary authorities were unaware that a change in the preference for excess reserves had occurred. Some 46 years later, the Federal Reserve may be making a similar mistake. By concentrating on a narrow view of aggregates targeting, monetary policymakers may adopt a stance that is unnecessarily tight.

The Federal Reserve now, however, also faces an additional constraint. Even if it becomes necessary to abandon strict aggregates targeting, it is not clear the authorities can afford to do so. A bad reputation is hard to live down. As a result of policy inconsistencies during the late 1960s and much of the 1970s, the monetary authorities suffered a tremendous loss of credibility. In fact, it was only through their strict adherence to pre-set target levels of money growth from October 1979 through mid-1982 that the market was finally convinced Fed policymakers were serious about bringing inflation under control. To abandon aggregates targeting now would endanger this hard-won credibility. Because of past experience, the only way the markets can be certain the monetary authorities are not engaging in inflationary policies is by the Federal Reserve's adherence to its self-imposed aggregates targets.

Thus, owing in large part to its own credibility gap, the Fed is now confronted with a crucial policy dilemma: If it tightens but money growth proves to have been largely demand-determined, the U.S. recovery will be snuffed out and the world economy put under renewed strain. On the other hand, if it does nothing and the money bulge turns out to be primarily the result of supply forces, the Fed will lose its credibility completely and the world will be exposed to a new boom-bust cycle. In short, the Fed finds itself tied to a policy that may be too confining, given the confusion over the source of the recent rapid money-supply growth.

Paradoxically, what the Fed needs to free up its operating strategy for possible expansive actions may be some sort of institutional change that would limit its ability to engage in inflationary policies—perhaps a legal obligation to maintain a fixed exchange rate or gold cover. Such a limit, however, would at the same time have to be devised in a way that would allow the Fed enough flexibility to respond to temporary and cyclical changes in money demand.

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